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Endogenous regionalism

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Abstract: For more than a decade regionalism has been on the rise in the global economy. Based on the concept of allocative efficiency, standard trade theory regards regionalism as a form of protectionism. The paper confronts this view with an institutionalist explanation and draws on recent research on the role of specific investments into international market access, uncertainty and asymmetric information in policy coordination. A distinction between regionalism and regionalist policies is proposed. Endogenous regionalism reflects the economic forces of path-dependent comparative advantage and manifests the embeddedness of trade relations in social networks. Regionalism translates into regionalist policies via political entrepreneurship in policy networks that aims at stabilizing expectations about future market access and balancing negotiation power in a multilateral setting. Regionalism is thus presented as the standard case in global economic integration between the two extremes of unilateral liberalization and complete multilateralism.

1. Regionalism out of the closet

The new upsurge of regionalism in the world economy is attracting much attention, in particular with respect to Asia and to the increasing role of the US trade policy as a driving force (Gordon, 2005). In the debate over regionalism economists continue to fight a normative struggle in favour of multilateralism, to which recently the emphasis of the virtues of unilateral liberalization has been added with a vengeance (Lindsey 2000; Bhagwati, 2002). Their recommendation is mostly based on the neoclassical Vinerian analysis of trade creation and trade diversion. This focus on the fundamentals of allocative efficiency supports the normative case that discrimination among trading partners must always be a bad policy. From this perspective, bad policy can only be caused by bad intentions, so that the emergence of regionalism is almost exclusively related to the political economy of interest groups and hence is debunked as a form of protectionism, with one of the major villains in this story being the EU (Pomfret, 1997: 88ff., 264ff.; Panagariya, 2002).

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In this paper I wish to approach the topic of regionalism in a foundational way in order to present an analytical alternative to the standard approach. I argue that precisely the *concomitance* of regionalism and multilateralism is a confirmation of another view on economic reality, i.e. the 'markets as networks' perspective. In markets as networks, regionalism emerges as the natural way to solve certain institutional problems in trade and trade policy.

To get concepts clear, I use 'regionalism' to describe a pattern of generative forces of regionalist trade policy in terms of preferential trading agreements in the broadest sense.[1] Those generative forces may result from a relatively deep regional integration through trade and investment, a common history, or political alliances, among other contributing factors. Under certain circumstances, they translate into the formation of a regional trade policy, which does not only include tariffs but all other forms of intraregional policy coordination, such as the coordination of product standards.

The simple, yet fundamental point that I wish to make is that the optimal trade policy prescribed by standard trade theory contradicts the fact that interaction in markets and politics is always taking place in *networks of actors* who need to communicate with each other. I confront the imagined state of the economy with actors who do not need to talk with the actual state in which individual action becomes only possible and effective via communication. This is because institutions are the necessary condition for any coordinated action, which are in turn embedded into language as the medium of communication (Searle, 2005). From that point of view, I show that the archetypical policy in standard trade theory, unilateral liberalization, is incomplete in the sense that it is a policy without an institution. As an institutional fact, however, it needs to be grounded in communication between *both* sides involved, i.e. networks of trading nations. In a nutshell, regionalism emerges as the *standard case* of a real-world community of discourse between the imagined extremes of autistic unilateralism and the all-inclusive multilateral community of speakers.[2]

The network approach has recently gained increasing acceptance in the economic profession.[3] In the context of our topic, it compares with the general

1 The distinction between regionalism as an empirical phenomenon and regionalist trade policy as an active measure to create trade institutions with a less than global scope has been frequently adopted with reference to the Asia Pacific, see e.g. Drysdale and Garnaut (1993), OECD (1995), or Liu (2003).

2 Such a positive stance towards regionalism can be frequently found in evolutionary economics, see several papers in Mothe and Paquet (1996). Political science also gives a more complex and benevolent picture of regionalism, see e.g. Mansfield and Milner (1997), Wolfe (2001), or Ravenhill (2001, chapter 1).

3 See Rauch and Casella (2003). In evolutionary economics, Potts (2000) has made networks the conceptual cornerstone of a new microeconomics. Another point of entry of the network approach is the increasing interest of economists in economic sociology, in particular in the Granovetter (2005) tradition. This converges with the recent interest of economists in the cultural determinants of economic action, which some authors such as Greif (1994) relate to social structure in the network sense. Along similar lines, I have tried to build a comprehensive framework for analyzing international trade in Herrmann-Pillath (2001), for a condensed exposition see Herrmann-Pillath (2006).

equilibrium analysis of political economy, which tries to model the political process as an exchange between interest groups and political actors within a unified equilibrium approach to markets and politics (Grossman and Helpman, 1994). The network approach emphasizes the embeddedness of economic exchange into non-economic social relations. In particular, the network approach highlights the effects of social structure on patterns of communication. Communication, in turn, rests upon language as the medium through which institutions are created and enforced. Thus, the concept of networks links up with a series of other concepts reaching from communication to culture, which make up a theoretical framework substantially different from standard equilibrium thinking in economics.

That being said, a major concern of this paper is to demonstrate that an overly polemic juxtaposition of the standard approach with the network perspective would not pay due respect to the many important insights which have been uncovered by the recent attempts at integrating institutions into the general equilibrium setting, such as Bagwell and Staiger (2002). The final message of the paper, thus, winds up in the statement that there is in fact a convergence towards an enlightened network approach in international trade, which also sheds a conciliatory light on regionalism.

2. Trade policy without and with talk

Standard trade theory recommends unilateral liberalization as the optimal policy for countries which cannot influence world prices, i.e. which are 'small' ones in the sense of equilibrium theory (for an analytic statement, see Bhagwati *et al.*, 1998: 271ff.). Thus, 'smallness' is not defined via size in terms of population or GDP, but basically depends on the market structure in the different branches of industry. Although the argument seems to be naïve with respect to real-world politics, its importance and significance cannot be underestimated, because it also underlies the Vinerian trade diversion story. Its very core is the belief that open markets deliver the highest welfare gains to everybody, since they allow the competitors with the lowest comparative costs to prevail in competition. Even if other countries do not open up their markets, unilateral liberalization remains the optimal policy, because the resulting trade imbalances will put pressure on relative money prices in both countries until a level of price competitiveness will be achieved that allows exporters of the liberalizing country to overcome the impediments to trade erected by the other countries.

Unilateral liberalization – setting an institution, too

The previous argument boils down to a sort of autistic rationality in the sense that the rational policy can proceed without any communication with the other actors (explicitly, see Krishna and Mitra, 2005). Free trade is the automatic result of a 'pre-stabilized harmony' among rational policy monads. As a consequence, there are only two explanations for the observed failure of unilateral liberalization to become the almost universal trade policy:

- firstly, a country might be relatively large so that market power allows it to pass-through the tariff costs on to the exporters of the other countries and thus to improve its terms of trade, and
- secondly, there are special interests which prevail over consumer interests for reasons well established by political economy, such as the lower costs of organization in geographically concentrated industries as compared to the dispersed consumers (for a survey, see Rodrik, 1995).

Regarding the second point, one common result is that democracy may always show a strong tendency towards protectionism, because differential access of interests to the political market is a universal phenomenon (Grossman and Helpman, 2005). Indeed, free trade can only be the outcome of a fully fledged politico-economic equilibrium, where all relevant interests are able to overcome the barriers to entry into the political market which thus becomes a perfect one corresponding to the perfect goods market (Grossmann and Helpman, 1994; Mitra, 1999). In comparison, the first argument is an empirical one. The most interesting question here is whether departures from the ideal-typical conditions of general equilibrium (i.e. full information, zero transaction costs etc.) imply that market power may be a more universal phenomenon than implicated by the mere relative sizes of countries. Indeed, the observed elasticities in trade point towards this hypothesis (Irwin, 1996: 222f.).

I wish to adopt a different perspective in considering unilateral liberalization as being the creation of an institution. The standard view suggests that unilateral liberalization is the very simple policy act of just scrapping tariffs, i.e. demolishing an institution. However, even if we leave the intricate issues of the equivalence of tariffs and non-tariff impediments to trade aside, the scrapping of a tariff amounts to more than just the negative act of desisting a government intervention. Unilateral liberalization is an act of institutional creation, because there must be a coordination of mutual expectations on both sides of the trading relation with regard to the *future state* of this relation. This problem becomes even more complex if we discard the common simplification of analyzing 'countries' but explicitly distinguish between political and market agents, while going beyond the narrow notion of interest group politics.

The issues at stake can be easily identified if we just ask about the reaction of the exporters on the announcement of unilateral liberalization. Three problems surface under the assumption of incomplete and imperfect information and positive information and transaction costs.

- First, how do exporters know about their competitiveness relative to market incumbents? The simple comparison of autarcy prices implies that costs of learning, structural adaptation, and building trading capacities are negligible. If they are not, relative competitiveness may be uncertain, and so is market response too. This means that dynamic comparative advantage is actually a discovery process with strong learning effects (Bernard and Jensen, 1999; Melitz, 2003).

- Second, unilateral liberalization will only trigger the standard exporters' reactions if they believe that the policy will continue in the future. The more specific and irreversible the investments into market access and exporting capacity become, the stronger the impact of the credibility of the announced policy on the emerging trading patterns. This is a classical Williamsonian hold-up problem which has been put into the centre of the institutional analysis of world trade by Yarbrough and Yarbrough (1992).
- Third, the capability of the liberalizing government to achieve credibility and trust may be limited. Without third-party enforcement, the policy has to face information asymmetries between the policy maker and the exporters, and there are deep uncertainties regarding the maintenance of the policy under changing political fortunes and economic environments. There are fundamental limits to the transmission of information about trade policy, its true intentions, and the true state of affairs (Feenstra and Lewis, 1991).

Hence, unilateral liberalization confronts an information problem that needs to be overcome by communication. Lack of information results in uncertainty over policy outcomes, which may prevent the expected market reactions from emerging. For example, very often even *ex post* winners from liberalization heavily discount the expected gains under uncertainty *ex ante*, a behavioural pattern that might be reinforced by established psychological mechanisms such as loss avoidance (Fernandez and Rodrik, 1991).

In these arguments, specific investments into exporting capacity play an essential role. This becomes even more salient if we consider dynamic effects in the interaction among political and market actors (following McLaren, 1997, 2002). In particular, market power becomes an endogenous variable. Consider the following. If liberalization proceeds gradually, exporters might start to build specific capacities to export into the liberalizing country. Further, if the country is becoming relatively more open than other competing importers, it may develop into a major target market for the exporters. Both trends reinforce the emerging dependency of the exporting country on the liberalizing country. As a result, bargaining power among governments is perceived to shift (remember the Canadian debates in the eve of NAFTA). This has two effects. First, the incentives for applying an optimum tariff policy increase, such that the unilateral liberalization becomes a time-inconsistent strategy. Second, if exporters anticipate this endogenous reversal of liberalization, they will not specialize on building export capacity in the first place and will try consciously to diversify across target markets. Thus, the gains from liberalization will not be as large as expected from the viewpoint of standard theory.

We learn that there are several additional conditions for the success of unilateral liberalization which are by no means innocuous, namely: almost complete information about relative competitiveness, low costs of adaptation to liberalization and low specificity of investments into the capacity to export, and institutional mechanisms to allow for a credible communication of trade policies. The latter refers to mechanisms to transfer information about the true intentions of the liberalizing government and to reliable scenarios of the long-run economic and political context which determines the incentive structure under which policy is and will be formulated. These conditions cannot be taken for granted, and this explains why true unilateral liberalization is a very special case in the history of global trade policy.[4]

I venture the hypothesis that the conditions for unilateral liberalization may have actually become less warranted today as compared to the nineteenth century, which is often quoted as having been its heyday. Today, the determinants of comparative advantage are more volatile and hence uncertain because footloose determinants such as knowledge and organization have become dominant, i.e. fixed relative factor endowments are no longer the beacons for the *perception* of comparative advantage. This increasing uncertainty is further accentuated in the context of intra-industry trade in which idiosyncratic differences in demand are driving forces of export growth. Once demand characteristics interact with competitive advantages, marketing and distribution may dominate production technology as determinants of relative export success. Investment in marketing capacity is mostly specific to the target market, so that the 'hold up' problem in specialization will become more salient.[5] On the other hand, the political context of trade policy has become much more complex; the development of the multilateral trade agenda notwithstanding. This effect is heightened by the increasing importance of trade impediments, which have a much higher information complexity than the tariff, such as sanitary standards. Without any need to invoke special interests, political conditions in modern democracies have become much more difficult to understand and to forecast, so that the prerequisites for credible communication of policies are shaky. In

4 I cannot go into the historical details here. For example, Bernhofen and Brown (2005) show that the unilateral opening-up of Japan in 1859 triggered a smooth and fast adaptation to comparative advantage. However, in this case there was almost perfect information *ex ante* about comparative advantage and export potential because on both sides a large share of the export goods either did not exist in one of the countries (such as certain industrial goods) or were very special products such as tea and silk with high market transparency. In comparison, the unilateral liberalization in Great Britain after the repeal of the Corn Laws is a much more complex case. There is even a scholarly dispute about the measurement of the comparative degree of protection during the nineteenth century. Further, it is debated how far the British policy actually expected reciprocity, given the fact that it eventually winded up in reciprocal trade policies. Further, even supporters of the unilateral liberalization story concede that a major motivation for people such as Cobden was the belief that free trade is part and parcel of the evangelical mission to impose Christian values on the globe. For surveys of the British case, see Fremdling (1988) and Conybeare (2002).

5 Yarbrough and Yarbrough (1992) put the specificity of production specialization at the centre of their analysis. However, following Harris (1989) and Engel and Rogers (1998) I extend this argument and put specific investments into marketing and distribution in the first place.

sum, I argue that precisely the modernization of the global economy has raised the informational and communicative needs for a successful coordination of all players (in more detail, see Herrmann-Pillath, 2000). Thus, trade policy with talk dominates trade policy without talk.

The paradox of multilateral liberalization

To sum up our argument so far, I posit that unilateral liberalization cannot be an optimal trade policy in both empirical and theoretical terms, because under realistic and general conditions it fails to deliver the signals that are needed to create the patterns of specialization that underlie the increasing trade flows. The linkage among trade policies of different countries is the only way this problem can be solved. Standard trade theory so far misses to highlight this point because it abstracts from information and transaction costs in both the market and politics. This argument should be neatly distinguished from the well-received case for reciprocity, which is based on the need for mutual sanctions in a repeated tariff game (e.g. Dixit, 1996).

My point can also be approached from the perspective of the recent treatment of multilateral liberalization by standard theory. Frequently, multilateral liberalization is said to solve a prisoners' dilemma in liberalization, which results from the time inconsistency of unilateral liberalization (e.g. Hoekman and Kostecki, 2001: 25ff.). As we have seen, this time inconsistency is not the general case but depends on the degree of the specificity of investments into market access. In its standard form, it is simply an artificial result of generalizing the two-country case without paying attention to the fact that the prisoners' dilemma dilutes with a growing number of trade partners (Snidal, 1993). Thus, in the standard framework the need for multilateral liberalization is not easy to justify. The most convincing argument points toward the possibility of committing a governments' policy against domestic interest group politics, thereby stabilizing exporters' expectations in general.

In a nutshell, we arrive at a paradox of multilateralism. Multilateral agreements are of special value if they allow sanctioning of deviant behaviour by collective action (Maggi, 1999). The need for multilateralism actually rests upon a dispersal of sanctioning power, which leaves single countries powerless. Yet, if relative power is measured by means of the power to change the distribution of gains from trade through terms-of-trade effects (which is the only economically relevant expression of power, see Bown, 2002, 2004), then precisely the dispersal of power implies that the countries would adopt unilateral liberalization as the only rational strategy. Hence, multilateralism turns superfluous. Obviously, the original argument presupposes a highly skewed distribution of size, which requires a large number of weak countries to flock together against a villain. This stands in direct contradiction with one of the most famous explanations of the emergence and stability of multilateral regimes, i.e. the hegemonial theory (for a critical survey, see Gilpin, 2001: 93ff.). Here, the paradox repeats itself, namely that, on the one hand, it is assumed that the power differential enables the hegemon to enforce the multilateral regime, but, on the other, this differential strengthens his incentives to pursue an optimum-tariff protectionist policy.

As we see, the analysis of multilateralism runs into troubles if it tries to stay within the closed equilibrium system of standard trade theory, i.e. continues to rely on prices and hence the terms of trade as the only way to assess the economic effects of institutions. Further, this argument cannot help to explain the intricacies of real-world multilateral liberalization, in particular the specific way its components, such as reciprocity and the most favoured nation (MFN) rule, are related to each other. Standard theory mostly tries to explain these institutions as mechanisms to remedy the externalities that may emerge in a less than multilateral setting which allows countries to pursue an optimum-tariff policy and hence to drive a wedge between world prices and domestic prices (Bagwell and Staiger, 2002). Thus, the gist of the argument is still related to the methodological primacy of the general equilibrium system of prices and quantities, and hence to the fundamental theorem of the rationality of the unilateral liberalization. In other words, the institutions of the GATT are interpreted in a way that they allow for an internalization of all externalities, such that in the end multilateral liberalization becomes identical with unilateral liberalization. This is similar to turning the institutional framework into a setting in which all talk is ‘cheap talk’ and all information needed to anticipate the partners’ strategies is externalized in the institutional environment and the implicated incentives for action. Just as with unilateral liberalization, given the institutional framework of negotiations, all participants should know that liberalization is the optimal policy, and hence will converge on this. As Ethier (2004) has shown (concurring with our paradox above), this general equilibrium account of trade institutions is highly misleading already in empirical terms, because it implies that small countries would never need a multilateral agreement (which they seem to need in the real world), whereas large countries must be eager to control the mutual abuse of market power (which they are not, given the many exceptions and loopholes in the multilateral system tolerated by precisely the big players).

To sum up in one statement, to conceive of multilateralism as trade policy without talk is as misleading as understanding unilateral liberalization as autistic action. Subsequently, I wish to demonstrate that talk implies regionalism in a sense that regionalism is the general case of trade policy, and both uni- and multilateralism are only special cases. Talk transcends the market because it relates economic action to multidimensional networks among actors.

3. Regionalism: networking trade and trade policy

The standard case against regionalism is directly related to the case in favour of unilateral liberalization (for comprehensive statements, see Bhagwati and

Panagariya, 1996; Pomfret, 1997; Panagariya, 1999). There will be only incentives for the formation of a preferential trading area if, firstly, this enables the larger unit to impose an optimum tariff policy towards the rest of the world (supposing that preferences are of the customs union type), and, secondly, if the policy results in the protection of a less efficient producer in the preferential area to the detriment of the most efficient producers outside it. Thus, regional trading arrangements will certainly do harm to global welfare, and in most cases they will damage domestic consumers' interests. From the viewpoint of political economy, every preferential trading agreement is a cartel of governments to protect import-competing industries within the preferential area, which builds on the mutual trading of political benefits across domestic industries in the different member countries (e.g. Krishna, 1998).

This analysis can be extended to almost all policy dimensions of regionalism, insofar as they can be entirely reduced to their effects on the vector of relative prices between the domestic country and the rest of the world (e.g. Bagwell and Staiger, 2002: chapter 8). For example, once technological standards are unified in a region, this may affect the relative costs between internal and external competitors, if an adoption of the standard is relatively more costly for the latter. In other words, either the preferential agreement does not affect relative costs and prices, from which follows that it is irrelevant in economic terms (but may be important on political grounds), or it does, which implies that it falls under the verdict of inefficiency.

This raises the simple question: Why does regionalism appear to be a constant in global trade policy, even in the face of the lacklustre performance of many regional trading arrangements in the past, such as those among developing countries? In particular, precisely after the successful deepening of multilateralism through the establishment of the WTO the number of regional arrangements exploded. In the light of our previous considerations, this seems to be related to the fact that the standard analysis leaves the problem of communication out of sight, which is concomitant to every act of institutional creation. Communication is embedded into networks among political and economic actors. To apply the network perspective on regionalism, we need to distinguish between the generating forces and the policies themselves. The generating forces can be systematically approached through the concept of embeddedness (Granovetter, 2005). The policies can best be understood as network strategies among political actors.

Generating forces: networks, trade and path-dependent comparative advantage

Turning first to the generating forces, the idea of embeddedness seems to be closely related to the debate over 'natural trading partners' (Krugman, 1991; Frankel *et al.*, 1995). In the 1990s, this concept mainly referred to transport costs and to the argument that among geographically close countries trade creation would necessarily be larger than trade diversion. This is because a producer in a distant country might not be competitive in terms of total costs including transport, even if it enjoys comparative advantages in terms of production costs. This argument met considerable criticism; however, there is a valid core that becomes even more convincing if we consider not only transport costs but transaction costs in general. The straightforward point is that countries that are more similar to each other in a multitude of dimensions (institutional, cultural etc.) will show a stronger propensity to trade than countries that differ. Similarities reduce transaction costs and therefore shift comparative advantages between more 'distant' and 'closer' trading partners (Linders *et al.*, 2005).

In the context of recent theorizing, this causality can be endogenized in the sense of 'endogenous comparative advantage', which has been introduced in trade models with economies of scale (for a survey, see Junius, 1999). The only additional causal mechanism that we need is the existence of specific investments into market access, which also manifest the property of fixed costs so that simple scale effects can also be generated (Medin, 2003; Melitz, 2003). Consider a trader who needs to adapt to the demand in a specific target market and invests into specific production equipment, marketing capacity, and entrepreneurial skills. This triggers a process of convergence between the exporting and the importing regions which further lowers transaction costs because of increasing similarity (in the same vein, see Chisik, 2003). That is, even if in the first stage of that process the exporter were less competitive than a third-country producer, the emerging transaction cost differential would lead to a shift in comparative advantage.

If we assume that in the first stage information is incomplete and uncertainty is high, we can think of a scenario in which *ex ante* a third country producer is the most efficient one, yet the information about this has not been diffused. *Ex post* and after incurring the specific investments, the original exporter in fact achieves the position of the most efficient one, so that a regional arrangement might turn out to show high *ex ante* trade diversion and low *ex post* trade diversion, with the former, however, being a counterfactual. Thus, we conceive of regionalism as being an endogenous feature of the world economy in the sense that we can only observe *de facto* comparative advantages and will not be able to reconstruct *ex ante* patterns of trade (in more detail, see Herrmann-Pillath, 2005). Furthermore, from the political economy perspective there is the possibility that endogenous comparative advantage might finally change the incentives for protection so that the process might even end up in a multilateral liberalization (Freund, 2000; similar to Baldwin's, 1997 'domino theory'). The only difference between 'regionalistic *ex post* multilateralism' and '*ex ante* multilateralism' would be the resulting location of production, a difference which, however, could only be made in counterfactual terms, since the observational data would always imply that allocative efficiency reigns.

On the theoretical level, this phenomenon can be fixed systematically in the notion of *path-dependent comparative advantage*. The mechanism relies on the frequency dependence of the similarity between trading partners, which is a determinant of transaction costs and hence comparative advantage in terms of the sum of Northian transformation and transaction costs. Regionalism is the empirical manifestation of path-dependent comparative advantage.

This radicalization of the 'natural trading partners' hypothesis is supported by recent research on the costs of trade, which mostly use the workhorse of the gravity model.[6] There is a strong hysteresis effect in the sense that past trading relations significantly shape current trading relations, such as foregone Commonwealth preferences. Ethnic and linguistic similarity increases trade activity in relative terms. Even in the capital market, common history affects the patterns of capital flows among nations. On the other hand, political borders have a very strong dampening effect on trade, even if formal trade impediments have been lowered almost to a zero level. All this can be summarized in the general observation that international trade is strongly influenced by social networks in different shapes and of different kinds (Rauch, 1999, 2001).

In our theoretical framework, these observations can be further related to the most conspicuous aspect of globalization, namely foreign direct investment (FDI) flows orchestrated by transnational corporations (TNC). Obviously, the distribution of FDI is an important determinant of the relative similarity of regions, because FDI also transmit organizational patterns, informal norms of interaction, and might even impact on the legal institutional framework through the convergence forces emerging from locational competition. Indeed, especially with regard to the Asia Pacific, international production networks have been frequently identified as a 'market driven' pattern of integration that may even substitute for political integration via regional agreements (Arndt, 1993; OECD, 1995).

The theory of the TNC has become a very complex field ranging from 'eclectic approaches' (Dunning, 1993) to hard-nosed equilibrium models (Markusen, 1998). A common feature of many contributions is the emphasis on company-specific knowledge capital, which has properties of an internal public good. This public good can be exploited through FDI that protects the ownership in it. Furthermore, many contributions stress the 'markets versus organization' principle, so that the choice of FDI as in international entry mode much depends on the relative transaction costs of markets. Apart from the obvious effect of the global liberalization of capital flows, the recent upsurge of FDI can be easily explained within such a conceptual framework, because the importance of knowledge goods has increased considerably and the implicated

6 Recent analyses have shown that the gravity model can be fit into standard trade models, see e.g. Deardorff (1998). On the following, see the empirical studies by Amelung (1991), McCallum (1995), Eichengreen and Irwin (1998), Lundan and Jones (2001), or Flörkemeyer (2004), and on the capital market Guiso *et al.* (2005). For a survey on the costs of trade literature in general, see Anderson and van Wincoop (2004).

transactional patterns have become ever-more complex. As a result, often simple arm's length trade is a less effective entry mode, at least in the longer run. However, the 'markets versus organization' view conceals the fact that trade and FDI are not simply substitutes. Increasing distance may trigger FDI as a substitute for trade, given a trade-off between trade costs and the concentration of production to exploit scale economies. But increasing distance is frequently associated with cultural, political, and institutional dissimilarity, which increases the impediments for FDI as well as for trade, so that the interaction is rendered indeterminate (Ekholm, 1998; Linders *et al.*, 2005).

Thus, we can interpret the TNC as a trade-enabling organization and hence a transaction complementary to trade.[7] In that case, FDI emerges as a force that further deepens differential trade integration in regional units. The role of FDI in the opening up of market access for a range of exports is true for both sides of the interface between market and organization, i.e. supplier relations and marketing of products. Exporters in countries with low quality reputation can improve global market access via a TNC, which controls for quality and adds its brand reputation to the product, so that the TNC is complementary to trade (UNCTAD, 2002). The same holds for the marketing side. The more complex a product becomes, the more important are complementary services and particular measures of brand protection through quality control which are typically processed within TNC structures.

From that perspective, the TNC is just another network configuration that deepens regional integration in the sense of strengthening path-dependent comparative advantage. The interesting consequence, of course, is that 'regionalism' no longer needs to refer exclusively to geographically contingent regions, because similarity via FDI can dominate transport costs. On the other hand, the empirical record shows strong regional effects also in the distribution of FDI; for example, within Europe or within the Asia-Pacific.

Summarizing this section, we state that regionalism is closely related to networks that contribute to solving informational and institutional impediments to trade, which are the more important the higher the specificity of investment into market access. Networks support communication flows through which an increasing similarity across exporting and importing regions emerges, which in turn lowers transaction costs of trade. Thus, regionalism seems to be a natural feature of the global economy. This is the international economics complement to recent insights of the economic analysis of markets in general, which have shown that markets are always embedded into networks (Rauch and Casella, 2003).

7 In recent research, this phenomenon has been mostly discussed under the heading of 'fragmentation', see Feenstra (1998). Harris (2001) offers a model congenial to my argument, which shows that network externalities in communication can explain both the extension of trade and investment activity.

Political forces: multilateralism feeds regionalism

From our previous considerations, I conclude that there are strong generating forces of regionalism which are endogenous to international trade. However, this has no direct implications for explaining the increasing role of regionalist *policies* in the narrow meaning. Further, given the complexity of path-dependent comparative advantage, regionalist policy may not identify the right units because as long as high trade barriers impede trade, the information about efficient trading patterns has not yet been generated.[8]

My basic argument follows the second section, and I emphasize that I only concentrate on regionalist policies that lead towards the creation of regional agreements, which differs from the question of how existing regional bodies interact, and how their internal decision making is organized.

Regional agreements may serve to stabilize expectations of traders about future export possibilities, in particular if:

- market access requires a relatively high level of specific investments which will be sunk if export opportunities do not materialize in the future;
- multilateral agreements do not sufficiently target precisely those areas where the specific investments are necessary;
- multilateral agreements do not sufficiently cover the range of trade-enabling measures, and, in particular, FDI, so that uncertainty in those areas also increases uncertainty in future trade relations.

Interestingly, this means that multilateralism and regionalism are by no means substitutes but may be complements if growing trade is accompanied with increasing specific investments into market access. For example, the discrepancy between the speed of liberalization in GATT and GATS means that a lack of progress in the latter will generate regionalist forces in the former, precisely when multilateral agreements further intensify trade integration. The reason is that many services are complementary to trade (Hirsch, 1989). With the growing importance of standardization issues, with increasing technological complexity of products and services, and with the growing need to adapt to highly diverse consumer preferences, the perceived risks of market access increase. These can be mitigated if governments anchor liberalization commitments in regional agreements that supplement the multilateral process. In this regard, a regional arrangement does not even need to affect the trade relations directly, but can contribute to a stabilization of expectations by building reputational capital through an additional commitment to trade liberalization (following Kovenock and Thursby, 1992). Any breach of a regional agreement will damage the reputation of a government in the entire process of exchanging market access between countries, so that beyond multilateral agreements regional arrangements

8 A clear example was the COMECON, the trade patterns of which unravelled after marketization triggered the revival of 'natural' trading patterns, see e.g. Fidrmuc and Fidrmuc (2001).

contribute to the growth of a self-enforcing network of mutual commitments. This effect becomes stronger the deeper a regional agreement is embedded into other forms of political cooperation, such as security relations.

There is another argument why multilateralism can foster regionalism, in the sense that regionalism emerges precisely from progress in multilateralism. Multilateral liberalization proceeds through negotiation rounds, so that negotiation power is an important factor of political economy. This is a very important point, because the doctrine of unilateral liberalization abstracts from issues of relative power among countries. As we have already seen previously, market power is related to negotiation power because export dependence also affects the political dimension of the relations among governments. However, there is an even more general problem implicated in the distribution of the gains from trade.

In the standard view, relative power only reflects market power. The tacit assumption is that multilateral liberalization increases competition and hence curtails the scope for market power. The multilateral institutions are perceived to be neutral in distributive terms, so that the distribution of gains from trade is exclusively determined via the competitive market process. However, this assumption of neutrality cannot be taken for granted. Just as the scope and complexity of the multilateral process increase, the effects on the gains from trade multiply. The most important and politically highly visible example is the TRIPS agreement. There is a general agreement that the TRIPS agreement is not distributively neutral because it implies a particular distribution of property rights in technological knowledge which depends on the existing stock of knowledge capital, and because it causes a particular distribution of the costs of adapting to the TRIPS standard across countries (e.g. Finger and Nogués, 2002). This is true in spite of the fact that the TRIPS agreement is by no means a discriminatory formal institution. This is only one example where we can clearly draw the conclusion that relative power in the multilateral process affects the distribution of the gains from trade, if countries can exert a differential impact on the specific form of the formal institutions that are being created by multilateral fiat.

This implies that regionalism and multilateralism evolve in tandem because regionalism is the foremost strategic means to change relative bargaining power across nations (cf. with strong empirical support Mansfield and Reinhardt, 2003). This argument is related to the well-known point that regionalism may reduce the level of political transaction costs of multilateralism (Krugman, 1993). Even though this general argument is not fully convincing, because the relation between negotiation costs and the number of participants is not necessarily monotonously decreasing, it hits an important aspect because bargaining power will be partly influenced by bargaining capacity, such as the number of qualified experts available, the knowledge base etc. This bargaining capacity can be increased through the formation of regional blocs, because it can be financed and organized as a club good (Frattiani and Pattison, 2001). To this the more narrow argument is added that relative size matters in bargaining over trade policies, because of the implications for the distribution of markets shares in the export business.

Thus, the multilateral process triggers the regionalization of the negotiation process and hence is complementary to the formation of preferential trading agreements. This seems to be a major difference between the earlier waves of regionalism and the most recent one. The earlier waves were frequently linked to an outright rejection of the multilateral regime, such as in the efforts of many developing countries to become independent from the vagaries of the global economy. Recent regionalism is much more driven by changing the balances *within* the multilateral system.

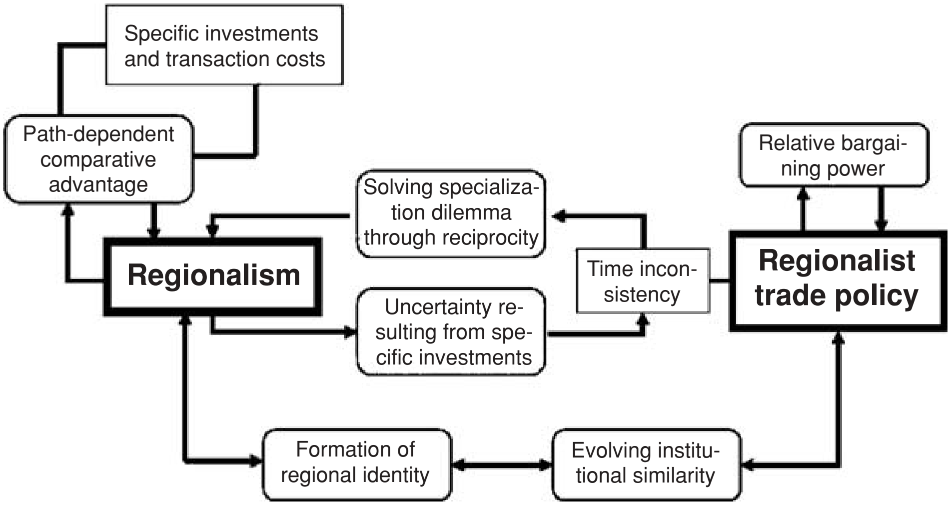
In that context, there is a final loop between regionalist policy and regionalism in the sense that regionalist policy may contribute to an increasing similarity between member countries. We have already emphasized the causal link via specific investments. We may now add the general observation that several regional agreements are explicitly related to the issue of regional identity. This is most salient in the case of the European project launched in the 1950s, but is also an issue in the Latin American and the Asian integration projects. One of the most important empirical proofs for this are the results of political science research into the role of military alliances and security coalitions for trade, which are mostly neglected by economists. As early contributions such as those of Gowa (1994) and Mansfield and Bronson (1997) have shown, political alliances can even overshadow the effects of preferential trade agreements, which implies that the embeddedness of regionalist trade policies into other determinants of the convergence of goals and perceptions across countries strongly determines trade patterns.

Taking stock of this section, we realize that there are endogenous forces of regionalist policies which interact with endogenous regionalism. In the same way as trade networks contribute to regionalization of trade, policy networks among governments lead to a closer regional coordination of trade policies. These networks enable the actors to overcome coordination problems that emerge precisely because the multilateral process advances. Thus, multilateralism and regionalist policies evolve in tandem.

4. Concluding remarks and some normative issues

Let me summarize my main argument in figure 1 which shows the major determinants of regionalism as outlined in this paper, with the reminder that this is not a complete statement of the causal patterns because we left the standard analysis of interest groups deliberately out of its scope. I do by no means deny that regional agreements may serve protectionist purposes. What I wanted to demonstrate is that an explanation of regionalism that exclusively rests upon the

Figure 1. Endogenous regionalism



politico-economic argument is misguided because it leaves the endogeneity of regionalism out of sight.

Figure 1 highlights the role of specific investments. This point is much more relevant than previously thought because of the fact that investments into the capability to transact with a particular partner are always specific and sunk costs, if the partners manifest idiosyncratic properties pertinent to transactions. In international trade, these are any target-market specific investments into marketing, distribution, transactional skills such as language or institutional knowledge, and in particular tacit knowledge in all those dimensions. Specific investments are a major determinant of path-dependent comparative advantage and hence of the dichotomy between counterfactual *ex ante* efficiency and factual *ex post* efficiency. At the same time, specific investments generate a hold-up problem of unilateral liberalization that turns reciprocal liberalization into the institutionally more powerful strategy, which lowers the level of uncertainty of export decisions. Trade policy with talk can overcome the specialization dilemma that results from the reluctance to specialize according to comparative advantage. Regionalist trade policies can – but need not – support the multilateral process of liberalization in particular if the latter does not offer solutions pertinent to specific investments into exports. This complementary role of regionalism and multilateralism is further strengthened by the role of regionalist policies in achieving power balances across countries in the negotiation process. Finally, the interaction between policies and trade may trigger a convergence within the region that contributes to building a regional identity via increasing similarity of institutions, standards, and perceptions.

This approach can be further distilled into the 'network paradigm of regionalism'. Regionalism is an essential feature of the entire process by which global economic integration emerges out of a complex interaction between economic and political entrepreneurs acting under uncertainty. This interaction proceeds through communication networks.

The network perspective can be very fruitful for the normative debate, too. Even with respect to fundamental issues of trade policy such as the role of reciprocity, there is very often a harsh contradiction between the economist's view and the political practitioners (e.g. Moore, 2003: 135f). The network perspective releases the parties out of this intellectual stalemate by opening up further degrees of freedom in understanding the interaction of different aspects of trade policy. Remarkably, from our analysis several normative considerations emerge which converge with some of the conclusions drawn by the standard analysis. In a brief sketch:

- Once the transaction cost concept is introduced and further differentiated into market and political transaction costs, it is straightforward to pay attention to Bhagwhati's and Panagariya's (1996) warnings against the 'spaghetti bowl phenomenon' in regionalism. This refers to trade impediments that emerge from the complexity of interlocking regional agreements. In general, adaptive efficiency of single regional agreements may be purchased at the price of an increasing level of transaction costs across all networked regional units. From this a normative principle of network parsimony emerges which is tantamount to Occam's razor as applied on institutions. That is, existing and new regional arrangements should be continuously assessed in terms of their effects on global transaction costs.
- Regionalist policies must be always aware of the fact that there is uncertainty regarding the *ex post* comparative advantages revealed by the liberalization of trade. This implies that they must be based on reasonable hypotheses about the structural determinants of trade between the member countries of an agreement and the rest of the world. This is also a major result of the authoritative World Bank (2000) survey on trade blocs where a set of 'rules of thumb' is presented such as: the more similar the factor endowments of countries and the larger the income differential across member countries, the higher the probability that the low-income country will loose from entering a regional agreement.
- The approach in this paper converges with the free-trade doctrine of the standard approach, albeit for an entirely different reason, namely the belief that free trade correlates with power balances across countries. In other words, free trade would mean a balance of power, and any specific institutional regime that approximates a balance of power is to be preferred on normative grounds. This differs from the standard allocative efficiency argument, because certain violations of allocative efficiency might be a necessary complement to institutional measures that improve the balance of power across countries.
- The design of information flows and of the rules of trade negotiations is of utmost importance for trade policy (Hoekman and Kostecki, 2001: 92ff.). The

economist should not primarily focus on the trade institutions proper when giving advice, but on the institutions that determine the process through which those institutions emerge. This is tantamount to the network design of trade policy.

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